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No. 93-404

IN THE

Supreme Court Of The United States

OCTOBER TERM, 1993

ARTHUR L. GUSTAFSON,
DANIEL R. McLEAN and
FRANCIS I. BUTLER,

Petitioners,

v.

ALLOYD CO., INC., a Delaware corporation,
f/k/a ALLOYD HOLDINGS, INC., and WIND POINT
PARTNERS II, L.P., a Delaware limited partnership,

Respondents.

Petition for Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

BRIEF OF RESPONDENTS ALLOYD CO., INC. AND WIND POINT PARTNERS II, L.P. IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI OF ARTHUR L. GUSTAFSON, DANIEL R. McLEAN AND FRANCIS I. BUTLER

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QUESTION PRESENTED

Whether section 12(2) of the Securities Act of 1933 applies to material misstatements or omissions in the sale of securities by controlling persons of the issuer.

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Respondents Alloyd Co., Inc. and Wind Point Partners II, L.P. respectfully request that this Court deny the Petition for Writ of Certiorari of Arthur L. Gustafson, Daniel R. McLean and Francis I. Butler.

STATEMENT OF THE CASE

In early 1989, Arthur Gustafson, Daniel McLean, and Francis Butler ("Sellers") decided to solicit bids for the purchase of Alloyd Co., Inc. ("Alloyd").[1] The Sellers were the controlling persons and sole shareholders of Alloyd: Gustafson, Alloyd's President, owned approximately 85% of its stock; McLean, Alloyd's Executive Vice-President, owned approximately 10%; and Butler, Alloyd's Vice-President in charge of marketing, owned approximately 5%.

The Sellers retained KPMG Peat Marwick ("Peat Marwick") to act on their behalf in soliciting bids. In July 1989, Peat Marwick contacted Richard Kracum, a general partner of Wind Point Partners II, L.P. ("Wind Point"), a venture capital partnership that invests in small companies offering unusually high growth potential. Peat Marwick subsequently sent Wind Point a "Profile" describing Alloyd's operating, financial, marketing and other characteristics. In September 1989, Wind Point submitted a written proposal to acquire Alloyd for approximately $41 million. Wind Point calculated the consideration in the proposal based on a multiple of Alloyd's 1989 earnings before interest and taxes ("EBIT"), determined by annualizing the eight-month interim financial figures provided by defendants.

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[1] Respondents state that there are no parent or subsidiary companies to be listed pursuant to Supreme Court Rule 29.1.

On October 17, 1989, the Sellers and Wind Point entered into a Letter Agreement setting forth the terms on which Wind Point would acquire Alloyd. The Letter Agreement specified that Wind Point would form a new corporation -- Alloyd Holdings, Inc. ("Holdings") -- to purchase the common stock of Alloyd.

Shortly thereafter, Wind Point received Alloyd's operating results for the nine months ending September 30, 1989. These financials indicated that Alloyd's 1989 annualized operating income was about $300,000 less than the annualized operating income figure calculated from the earlier financial results provided to Wind Point. Following this disclosure, the parties negotiated a reduction in the purchase price, reflected in a Letter of Amendment executed November 14, 1989.

In October and November 1989, Wind Point representatives had numerous discussions with McLean, whom Gustafson had designated as Sellers' spokesman on financial issues, concerning Alloyd's finances. McLean made numerous representations designed to allay Wind Point's concerns, raised by its advisors, about the reliability of the company's financial information. For example, McLean represented that his cost figures were conservative and that his method of calculating the company's gross profit margin overstated the actual cost of manufacturing (resulting in understatement of the company's earnings and inventory). When Wind Point suggested taking a physical inventory to verify the interim financials, McLean stated that such a step would not be cost-justified because any adjustment to inventory would be small.

On December 20, 1989, the Sellers and Holdings executed a Stock Purchase Agreement ("Purchase Agreement"). The Sellers provided Holdings with Consolidated Interim Financial Statements for the ten-month period ending October 31, 1989. These financials, referred to in section 4D of the Purchase Agreement as the "Latest Balance Sheet," stated that Alloyd had operating income of $3,646,397 and reflected an operating profit margin of 14.2% for the first ten months of 1989.

Because Wind Point had relied on the financial data supplied by the Sellers in determining Alloyd's purchase price, the Purchase Agreement contained representations regarding this information as an inducement to enter into the Agreement. Specifically, the Purchase Agreement represented that all of the financial statements and other financial data provided to the buyers fairly presented Alloyd's true financial condition. Section 4D, for example, warranted that the 1989 interim financial statements "present fairly on a consolidated basis the Company's financial condition and related results of operations." Section 4I warranted that there had been "no material adverse change in or any material adverse event affecting the business, financial condition, operating results, assets, operations or business prospects" of the company between the date of the 1989 interim financial statements and the closing.

The closing occurred on December 22, 1989. At the closing, the Sellers certified that the representations and warranties in the Purchase Agreement were "true and correct in all material respects" as of that date.

On February 12, 1990, Wind Point and Holdings discovered that the information provided by the Sellers had materially misstated Alloyd's 1989 inventory, operating results and profitability. The ten-month interim financial statement provided by the Sellers overstated Alloyd's actual inventory by over $1 million, and overstated its operating income by over 33%, or nearly $1.5 million for the full year 1989. The latter overstatement was particularly significant because Wind Point had based its purchase price on a multiple of Alloyd's 1989 operating income. Wind Point thus paid millions of dollars more than it would have paid had it known Alloyd's true 1989 income.

Alloyd and Wind Point subsequently filed suit against the Sellers in the United States District Court for the Northern District of Illinois, asserting claims for violation of section 12(2) of the Securities Act of 1933, 15 U.S.C. § 77l(2), as well as for breach of contract. Following extensive discovery, the parties filed cross motions for summary judgment. On May 29, 1992, United States District Judge Ann Williams entered an unpublished

Memorandum Opinion and Order granting the Sellers' motion, ruling that section 12(2) does not apply to the transaction between the parties. Judge Williams dismissed the pendent state-law breach of contract claim for lack of subject matter jurisdiction.

Wind Point and Alloyd appealed the summary judgment ruling to the Seventh Circuit Court of Appeals. In an unpublished Order, the Seventh Circuit vacated Judge Williams' May 29, 1992 Order and remanded the case for further proceedings, citing its ruling in Pacific Dunlop Holdings, Inc. v. Allen & Co., 993 F.2d 578 (7th Cir. 1993). The Sellers did not seek a rehearing before the Seventh Circuit, and instead filed a Petition for Certiorari on September 9, 1993.

In the meantime, the parties have refiled their cross motions for summary judgment. Defendants-Petitioners' motion seeks summary judgment on the section 12(2) claim on three separate grounds. Plaintiffs-Respondents filed a cross motion for summary judgment on the breach of contract claim. These motions are fully briefed and awaiting decision by the District Court.

SUMMARY OF ARGUMENT

Because the District Court on remand may decide this case on other legal grounds that would not require this Court to address the question posed in the Petition, the issuance of a writ of certiorari would be premature at the present time. Further, Ballay v. Legg Mason Wood Walker, Inc., 925 F.2d 682 (3d Cir. 1991), cert. denied, --- U.S. ---, 112 S. Ct. 79 (1991), the case cited by the Petitioners to support their claim of a direct conflict among the circuits concerning the applicability of section 12(2) of the Securities Act of 1933 to secondary market transactions, involves brokerage transactions. Ballay does not address the scenario posed in the present case -- i.e., a securities transaction involving the sale of stock by shareholders who control the issuer. The Seventh Circuit correctly decided, based on the plain meaning of the statute and its legislative history, that section 12(2) applies to such postdistribution transactions.

ARGUMENT

I. THE PETITION SHOULD BE DENIED BECAUSE THE ISSUES RAISED COULD BE MOOTED BY THE DISTRICT COURT'S ACTIONS ON REMAND.

The Petitioners seek review of an unpublished, interim opinion in which the Seventh Circuit vacated the judgment of the District Court and remanded for further proceedings in light of the Seventh Circuit's decision in Pacific Dunlop Holdings, Inc. v. Allen & Co., 993 F.2d 578 (7th Cir. 1993). Respondents respectfully suggest that review at this juncture would be premature.

At present there is a fully briefed summary judgment motion that raises other issues pertinent to section 12(2) and which could well moot the issues raised in the Petition for Certiorari. Indeed, that is the precise reason the Seventh Circuit vacated and remanded the case, rather than deciding it on its merits -- because other substantive issues had yet to be considered by the District Court.

The District Court's Order that Alloyd and Wind Point had no claims under section 12(2) was based solely on the ruling that section 12(2) does not apply to secondary transactions. In so holding, the District Court specifically stated that it had not considered certain of the Sellers' other arguments, including the argument that Alloyd and Wind Point could not prove the substantive elements of a section 12(2) claim "since, upon review of the defendants' arguments, the court finds that these arguments will not affect our decision to grant defendants' motion for summary judgment because the plaintiffs cannot bring a claim under Section 12(2)." App. at 14 n.4. If, on remand, the District Court were to determine that the Sellers are not able to prove the substantive elements of a section 12(2) claim or that one of their other legal arguments precludes this claim, there would be no need to address the issues raised in the present petition.

In light of the interlocutory nature of the proceedings, Respondents respectfully suggest that it is too early to determine whether this Court's intervention is necessary to resolve the present dispute.

II. THE PETITION SHOULD BE DENIED BECAUSE THERE IS NO DIRECT CONFLICT AMONG THE CIRCUITS AS TO WHETHER SECTION 12(2) APPLIES TO THE SALE OF SECURITIES BY CONTROLLING SHAREHOLDERS OF THE ISSUER.

The case cited by Petitioners to support their claim of a direct conflict among the circuits -- Ballay v. Legg Mason Wood Walker, Inc., 925 F.2d 682 (3d Cir. 1991), cert. denied, 112 S. Ct. 79 (1991)[2] -- did not decide the applicability of section 12(2) to the sale of securities by shareholders who control the issuer. The Third Circuit addressed the applicability of section 12(2) to a suit against a brokerage firm for alleged misrepresentations in a secondary transaction. In contrast, Pacific Dunlop, on which the Seventh Circuit relied in remanding this case to the District Court, addressed a very different scenario: a transaction in which a plaintiff purchased stock directly from controlling shareholders by means of a purchase agreement.

Indeed, even the Ballay court, in rejecting application of section 12(2) to brokerage transactions, quoted language from the legislative history that supports the application of section 12(2) to sales by shareholders who control the issuer. The Ballay court noted that the 1933 Securities Act "does not affect the ordinary redistribution of securities unless such redistribution takes on the characteristics of a new offering by reason of the control of the issuer possessed by those responsible

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[2] After the Sellers filed their Petition, the Eleventh Circuit followed Ballay in First Union Discount Brokerage Services, Inc. v. Milos, 997 F.2d 835 (11th Cir. 1993), a case also involving brokerage transactions. Milos relied exclusively on the Ballay court's analysis, and, like Ballay, reached the court of appeals after a trial on the merits.

for the offering." Ballay, 925 F.2d at 690 (quoting H. Rep. No. 85, 73d Cong., 1st Sess. 5 (1933) (emphasis added). Because Ballay involved redistribution through a broker, the Third Circuit did not need to decide the extent to which section 12(2) applies to redistributions that take on the characteristics of new offerings because the securities were sold by persons who controlled the issuer.

Thus, Ballay and Pacific Dunlop present two related, but conceptually different, issues. Many of the cases cited by Petitioners to support their claim of a direct conflict among the circuits and which allegedly "favor limiting Section 12(2) to initial distributions," see Petition at 11 & n.1, involve brokerage transactions. Because this case involves a sale of securities directly by controlling stockholders pursuant to a stock purchase agreement, there is no clear conflict between the Third and Seventh Circuits on the issue presented by this case.

III. THE SEVENTH CIRCUIT'S INTERPRETATION OF SECTION 12(2) IS SUPPORTED BY THE PLAIN LANGUAGE OF THE STATUTE AND ITS LEGISLATIVE HISTORY.

The Seventh Circuit's determination that section 12(2) applies to transactions involving the sale of securities by means of written misstatements and omissions by shareholders who control the issuer is amply supported by the language of the statute. Although resort to legislative history is unnecessary, the legislative history also supports the applicability of section 12(2) to transactions involving the sale of stock by controlling shareholders of the issuer.

This Court has repeatedly emphasized that the starting point in construing a statute is the language itself. See Landreth Timber Co. v. Landreth, 471 U.S. 681, 685 (1985); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197 (1976). Nothing in the language of section 12(2) limits the provision to initial offerings. Indeed, its language is broad enough to cover any sale of securities, as the Seventh Circuit recognized even prior to its decision in Pacific Dunlop. See Short v. Belleville Shoe Mfg. Co., 908 F.2d 1385, 1390 (7th Cir. 1990) (Easterbrook, J.)(noting that

section 11 deals with errors and omissions in registration statements, section 12(1) deals with sales in violation of section 5, and section 12(2) "addresses all other forms of materially incorrect or misleading selling literature and oral communications in the sale of a security."), cert. denied, --- U.S. ---, 111 S. Ct. 2887 (1991).

Nor does the definition of "prospectus" in section 2(10) of the Act support the narrow interpretation imposed by Ballay and urged by Petitioners. Section 2(10) defines "prospectus" broadly to include "any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security . . . ." 15 U.S.C. § 77b(10). Although Petitioners contend that "[t]he Agreement here does not comport with any obvious interpretation of the word 'prospectus,'" Petition at 13, the Seventh Circuit properly rejected this argument in Pacific Dunlop.

As the Seventh Circuit recognized, shortly after enactment of the 1933 Act, the Securities and Exchange Commission acknowledged the breadth of the term "prospectus" in an opinion of its general counsel stating that the term includes within its meaning "every kind of written communication which attempts or offers to dispose of, or solicits an offer to buy, a security for value, or which constitutes a contract of sale or disposition of a security for value." Securities Act Release No. 33-2623 (1941), reprinted in 11 Fed. Reg. 10964 (1946). This opinion was incorporated in substance into the language of section 2(10) through a 1954 statutory amendment. "[T]he congressional reports explicitly referred to the 1941 opinion and stated that the amendment was adopted in order to avoid any implied repeal of 'settled interpretations' of the original text of Section 2(10)." Pacific Dunlop, 993 F.2d at 583.

Further, the context of section 12 does not require that the broad definition of prospectus in section 2(10) be rejected for a more narrow definition of the term in section 12(2). The definitional section 2 of the 1933 Act begins with the phrase "[w]hen used in this title, unless the context otherwise requires . . . ." Although the Act contains more than one

definition of a prospectus,[3] as the Seventh Circuit observed in Pacific Dunlop, "we cannot say that the structure of the 1933 Act, the text of section 12, and in particular the context of the word 'prospectus' in section 12(2), require a definition of prospectus contrary to the broad definition of section 2(10)." 993 F.2d at 588.

Finally, although resort to the legislative history is unnecessary since the "plain language opposes any hint of a limitation to initial distribution," A. Hirsh, Comment, Applying Section 12(2) of the 1933 Securities Act to the Aftermarket, 57 U. Chi. L. Rev. 955, 984 (1990), the legislative history does not require that application of section 12(2) be limited to initial offerings. First, as shown above, even the House Report -- cited in Ballay and by the Petitioners to support the claim that section 12(2) applies only to initial transactions -- contemplates its application to redistribution sales by controlling persons of the issuer. See H. Rep. No. 85, 73d Cong., 1st Sess. 5 (1933). Second, unlike the House, the Senate "proceeded along a different course." Pacific Dunlop, 993 F.2d at 590. The Senate version of the 1933 Act "allowed recovery for fraud in the sale of 'any security,' not just those involved in initial offerings." Id. "Although the Senate did not extensively explain its version, the differing texts display a distinctive treatment on their face." Id. at 591.[4]

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[3] For example, Section 10 sets forth what must be included in a statutory prospectus that is part of a registration statement.

[4] The Seventh Circuit correctly rejected an argument that the Senate's final version intended to limit the civil liability provisions to initial offerings. As the Seventh Circuit recognized, "[t]aking for granted (without deciding) that the language of section 12(c) limits the provisions of the Act to initial offerings, the conference report stated that the 'substantially similar [civil liability] provisions of the Senate amendment did not apply to any of the securities exempted under the Senate amendment." Pacific Dunlop, 993 F.2d at 591. Thus, the report "interpreted section 9 of the Senate's version [the Senate version of section 12(2)], which began with the phrase 'Every person acquiring any security,' as language that 'expressly provided' that the limitations of section 12(c) would not have applied." Id. at 591-92.

A House and Senate conference resulted in the final version of the 1933 Act. As the Seventh Circuit recognized, after the conference, "the managers on the part of the House attached a commentary to the final version, addressing the distinctions and the resolution between the previous versions . . . ." Id. Significantly, "[t]he commentary by the House's managers did not mention their version that had limited the application of section 12(2) to fraud in a prospectus or oral communication; rather, the report recognized the Senate version, which applied section 12(2) to the distribution or sale of a security." Id. at 592. The Seventh Circuit observed:

> And there is no legislative history in the Senate that requires the "sale" of a security be limited to initial offerings. In the face of the Senate's broad wording, that civil fraud applies to any sale, the commentary by the House's managers after the joint conference remained silent. Although the legislative history in the House report can be read to focus solely on those offerings pursuant to a registration statement and prospectuses . . . the Senate's version of the 1933 Act and the conference report do not confirm the House's comments.

Id. (emphasis added). When considered in its entirety, the legislative history of section 12(2) supports its application to secondary transactions. Moreover, even the House Report relied on by the Petitioners contemplates application of section 12(2) to redistributions which, because of "control of the issuer possessed by those responsible for the offering," take on the characteristics of new offerings.

The plain language of the statute supports application of section 12(2) to secondary transactions, and, as demonstrated above, the legislative history does not require the contrary. The Seventh Circuit correctly determined that section

12(2) applies to secondary transactions involving the sale of stock by controlling persons -- the factual scenario of the present case.

CONCLUSION

For the foregoing reasons, Alloyd Co., Inc. and Wind Point Partners II, L.P. respectfully request that this Court deny the Petition for Writ of Certiorari of Arthur L. Gustafson, Daniel R. McLean and Francis I. Butler.

Respectfully submitted,

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